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FISCAL IMPACT STATEMENT

LS 6858 | **NOTE PREPARED:** Feb 4, 2015
BILL NUMBER: HB 1349 | **BILL AMENDED:**

SUBJECT: Various Tax Matters.

FIRST AUTHOR: Rep. Huston | **BILL STATUS:** As Introduced
FIRST SPONSOR:

FUNDS AFFECTED: X GENERAL | **IMPACT:** State & Local
X DEDICATED
FEDERAL

Summary of Legislation: The bill contains the following provisions:

Sales Tax - Double Direct Test: It eliminates the double direct test for the gross retail tax exemption for various transactions involving various types of tangible personal property. It specifies that the exemption applies if the tangible personal property is acquired for direct use or consumption in the production of tangible personal property when the person acquiring the property is occupationally engaged in the business of producing tangible personal property.

Income Tax - Adjustments, Deductions, and Credits: It eliminates various adjustments to income for purposes of determining Indiana Adjusted Gross Income (AGI). It also eliminates various income tax exemptions, deductions, and credits.

Indiana Earned Income Tax Credit: It uses the most recent Internal Revenue Code for determining the Indiana Earned Income Tax Credit (EITC).

Business Income Taxation: It provides that business income is all income apportionable to the state under the Constitution of the United States.

Repeal of Throwback rule: It also eliminates the taxation of income that is attributed to a state that does not have an income tax (the "throwback rule").

Market Based Sourcing: It adopts the sourcing of income using market based sourcing.

Intangible Expenses Add back: It broadens the addback to Indiana AGI related to intercompany interest expenses.

Tax Amnesty: It provides for a tax amnesty program.

The bill also makes technical corrections and conforming amendments.

Effective Date: July 1, 2015; January 1, 2016.

Explanation of State Expenditures: *Department of State Revenue (DOR):* The DOR will incur additional expenses to revise tax forms, instructions, and computer programs to reflect the changes made by the bill. With the exception of the required tax amnesty program, the DOR's current level of resources should be sufficient to implement these changes.

When the DOR conducted a tax amnesty program in 2006, the total cost was about $15.5 M. That included contracting with an outside collections agency to assist with the project because the DOR did not have the capacity or resources to contact all potential amnesty cases. It is unknown whether the DOR currently has the resources to conduct this project without outside assistance. The bill does not appropriate funds for a tax amnesty project. The additional funds and resources required could be supplied through existing staff and resources currently being used in another program or with new appropriations. Ultimately, the source of funds and resources required to satisfy the requirements of this bill will depend on legislative and administrative actions.

Explanation of State Revenues: (Revised) *Summary-* The table below summarizes the estimated impact of provisions of the bill. (Provisions with no fiscal impact were excluded.) Following the table are brief explanations of the provisions and potential revenue impacts. The provisions are categorized based on whether they are: (1) likely to increase state revenue, (2) likely to have no fiscal impact, or (3) likely to decrease state revenue.

Provision	Estimated Impact ($ in millions)		
	FY 2016	FY 2017	FY 2018
Sales Tax - Double Direct Test	($54.0 - $100.0)	($130.0 - $240.0)	($130.0 - $240.0)
Indiana Earned Income Tax Credit	$0	($12.8 - $15.8)	($12.8 - $15.8)
Tax Amnesty	$0	$109.0 -$159.0	$0
Market-Based Sourcing	$4.0-$5.0	$21.0- $28.0	$21.0-$28.0
Business Income	*	*	*
Repeal of Throwback Rule	($0 - $1.5)	($0 - $8.0)	($0 - $8.0)
Intercompany Interest Expense Add Back	*	*	*
Income Tax - Eliminating Adjustments, Deductions, and Credits	$0	$21.0	$21.0
Community Revitalization Enhancement District Tax Credit	*	*	*
Total	**($50.0- $96.5)**	**$8.2 -($55.8)**	**($100.8 - $214.8)**

* Indeterminable fiscal impact.

Likely to Increase State Revenue -

Tax Amnesty: Under the bill, the DOR would adopt emergency rules to establish a tax amnesty program for listed taxes due and payable for a tax period ending before January 1, 2013. The program would not last more than eight weeks and would end before January 1, 2017. Using the average and median collection rates of similar programs, the proposed tax amnesty program could collect about $109.0 M to $159.0 M.

(Revised) *Market-Based Sourcing:* The bill changes the apportionment of sales of services or intangibles from a cost of production method to a market-based sourcing method. Since corporate income is apportioned to Indiana based solely on a corporate taxpayer's sales, the difference in the method of sourcing the sales could have a significant impact on corporate taxpayers. The bill will generally increase the tax liabilities of corporate taxpayers that are out-of-state service providers and generally decrease the tax liabilities for corporate taxpayers that are engaged in service producing business in Indiana.

The revenue impact will likely begin in FY 2016 as corporations with liability periods ending in the first half of CY 2016 file their returns, but the full revenue impact will begin in FY 2017. This provision could increase revenue deposited in the state General Fund by about $4.0 M to $5.0 M in FY 2016 and $21.0 M to $28.0 M annually in FY 2017 and FY 2018. The long-run revenue impact could decline due to scheduled tax rate reductions and depending on the extent of tax planning and other behavioral changes by corporate taxpayers affected by the apportionment change. The estimates are based on an analysis of 2012 IMPLAN trade-flow data and the Revenue Technical Committee Forecast (December 18, 2014) for FY 2015 to FY 2017. The methodology also controls for the impact of behavioral change by corporate taxpayers. The behavioral response rate is based on econometric research estimating the tax base response to statutory and effective tax rate changes.

Business Income Taxation: The bill changes Indiana's definition of business income to all income that is apportionable to the state under the Constitution of the United States. This affects what income the taxpayer must apportion when computing Indiana source income. This will likely increase state revenue by an indeterminate amount particularly from gains on liquidating sales and certain unitary transactions. The revenue impact will likely begin in FY 2016 as corporations with liability periods ending in the first half of CY 2016 file their returns, but the full revenue impact will begin in FY 2017.

Intercompany Interest Expense Add Back: The bill clarifies the current law related to an add back of interest expense deduction taken on a corporation's federal income tax return for certain interest expenses paid, accrued, or incurred by the corporation with one or more members of the same "affiliated group" of corporations or with one or more foreign corporations. This provision could lead to an increase in compliance by taxpayers that disregard the current add back provision due to lack of clarity in the statute.

Income Tax - Adjustments, Deductions, and Credits: The bill eliminates 29 income tax adjustments, deductions, and credits beginning after December 31, 2015. The net impact of eliminating these provisions could potentially increase state General Fund revenue about $21.0 M each year beginning in FY 2017. [Please see the table at the end of this document for a complete list of the provisions eliminated by the bill.]

Income Tax - Community Revitalization Enhancement District Tax Credit: The bill also modifies the Community Revitalization Enhancement District Tax Credit. It states that expenditures made on residential property after December 31, 2015, are not considered qualifying investments when computing the tax credit amount. This provision will likely have an indeterminable, but insignificant impact, on state General Fund revenue beginning in FY 2017.

<u>*Likely to Have No Fiscal Impact*</u> -

Indiana Earned Income Tax Credit: Eliminating the references to advanced EITC payments will have no fiscal impact. Federal legislation signed into law August of 2010 repealed the advanced EITC effective December 31, 2010.

<u>*Likely to Decrease State Revenue*</u> -

(Revised) *Sales Tax - Double Direct Test*: The bill broadens the sales tax exemption for production inputs and exempts sales of certain production inputs that are not currently sales tax exempt. The bill does this by eliminating the requirement for exempt inputs to be <u>directly</u> consumed in <u>direct</u> production of a good and replacing it with a requirement for exempt inputs just to be <u>directly</u> consumed or used in production of a good. The bill also extends the exemption beyond the listed industries to include all businesses that produce goods.

The revenue loss will begin in FY 2016 as businesses purchase exempt items in the first half of CY 2016, but the full revenue impact will begin in FY 2017. The estimated revenue loss associated with this provision may range from $54 M to $100 M in FY 2016 and $130 M to $240 M each fiscal year thereafter. The probability of the revenue loss being smaller than projected is minimal, but the probability of the revenue loss being larger is significant. LSA bases this assessment on (1) the potential variability of factors used for the estimate, including the estimated business share of sales tax, the estimated share of taxable input purchases by producers, and the assumed shares of taxable input purchases that could be exempted from taxation under the bill; and (2) the scale of manufacturing and other production industries in Indiana and the scale of input purchases by these industries.

[Sales tax revenue is deposited in the state General Fund (98.848%), the Motor Vehicle Highway Account (1%), the Commuter Rail Service Fund (0.123%), and Industrial Rail Service Fund (0.029%).]

Indiana Earned Income Tax Credit (EITC): The bill modifies the computation of the Indiana EITC. Currently, the credit equals 9% of the federal EITC as it existed before amended by the *Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010.* The bill updates the federal EITC reference to the date the Internal Revenue Code (IRC) is referenced in Indiana statute. This will increase the credit provided to individuals and reduce state General Fund revenue by the amount of credits claimed. The revenue impact will likely begin in FY 2017 when individuals file their tax year 2016 returns. This provision will likely reduce state revenue by about $12.8 M to $15.8 M per year. Future revenue losses will depend on the number of claimants, federal law, and whether the reference in Indiana statute to the IRC in effect on a particular date is updated to include such legislation.

(Revised) *Repeal of Throwback Rule:* The bill changes the apportionment method of corporate business income for corporate taxpayers that: (1) ship property from Indiana to a purchaser located outside Indiana; and (2) are not subject to tax in the jurisdiction where the purchaser is located. Under current law, the sales described in (2) are assigned to Indiana under what is called the "throwback rule". Since Indiana uses sales as the basis of business income apportionment, the throwback rule increases the taxable business income for some corporate taxpayers.

It is estimated that the state revenue loss from eliminating the throwback rule could range from minimal to $8.0 M annually. The long-run impact could decline due to scheduled tax rate reductions. The estimated range is based on a review of econometric research on the impact of the throwback rule on the corporate tax base and revenue and an analysis of Indiana corporate tax return information.

Econometric research on the impact of the throwback rule on the corporate income tax base has been largely ambiguous. Some of the studies suggest that eliminating the throwback rule could lead to a revenue loss, but that the revenue loss might be offset to the extent that the change leads to an increase in taxable corporate income due to tax planning and other factors. However, some of the studies suggest that the throwback rule does not impact the corporate tax base on its own, but may impact the tax base when combined with other policy factors like the corporate tax rate and combined reporting requirements. Corporate tax return information suggests that less than 1% of corporate taxpayers are currently impacted by the throwback rule A simulation removing the throwback rule for these taxpayers indicates it would reduce the tax liability of these taxpayers. The final estimate assumes a behavioral response by corporate taxpayers could offset a portion of the simulated revenue. The behavioral response rate is based on econometric research estimating the tax base response to statutory and effective tax rate changes.

The bill is effective January 1, 2016, and the impact of the bill could begin in FY 2016, if taxpayers adjust quarterly estimated payments. The full year impact from the bill would begin in FY 2017.

<u>Additional Information</u> -

Sales Tax - Double Direct Test: In FY 2014, Indiana collected $7,004 M in sales tax revenue. It is estimated that about $2,330 M of the total sales tax collections was paid by businesses, with about $1,720 M of the total attributable to purchases of goods. These estimates are based on tax collection data, published research estimating the business share of sales tax, and industry sector input-output data from the U.S. Bureau of Economic Analysis (BEA).

This provision affects the taxability of certain goods purchased by Indiana's production industries. Any change to the taxability of the goods purchased by those sectors is likely to have a considerable effect on state revenue. The production industries of agriculture, mining, utilities, and manufacturing comprise nearly 38% of Indiana's gross state product. The production industries may account for between $550 M to $660 M of the total sales tax attributable to goods purchased by businesses. Those estimates include both final goods used by businesses and intermediate inputs that are used in production but fail to meet the current double direct test. The estimates are based on an analysis of the commodity use input-output tables published by the BEA. Each industry sector is analyzed to determine which commodities would be used as intermediate inputs into the production of other tangible goods or would be a final good used by the industry. The estimated revenue loss assumes that a share of each commodity identified as a production input fails the current double direct test and is taxable, but is directly used in production so it would be tax exempt under the bill. The lower bound estimate assumes this is a 5% share and the upper bound estimate assumes this is a 10% share.

Tax Amnesty: Under the amnesty program, applicable interest, penalties, collection fees, and costs would be excused on liabilities voluntarily paid or for which a payment program acceptable to DOR is established. Also, DOR would not seek civil or criminal prosecution of the taxpayer or issue an assessment, warrant, or demand notice against the taxpayer. However, if the taxpayer fails to pay the tax liability eligible for payment under the program, the liability would be subject to a doubling of penalties imposed or otherwise due. An exception to the doubling of penalties would exist for certain taxpayers who timely file an original tax appeal in the Tax Court, who have a legitimate hold on making the payment, who proves to the Commissioner that notice of the outstanding tax liability was never received, or who have established a payment plan with DOR. Additionally, a taxpayer would enter into an agreement that the taxpayer would not be eligible for any future amnesty program for the same listed tax. DOR would be required to enforce the agreement.

Indiana conducted an amnesty program in 2006, and it yielded $244 M in revenue. The table below contains the source of prior amnesty collections by tax type.

Tax Type	% of Amnesty Revenue
Corporate Income and Financial Institutions Tax	46%
Sales and Use Tax	25%
Individual Income Tax	24%
All other tax types	5%

The amnesty collection estimates are based on published research, the effectiveness of similar state amnesty programs, and the results of Indiana's prior amnesty program. The actual revenue from the proposed amnesty program depends on the total qualified tax liabilities, the success of marketing the program, and the liabilities of the taxpayers who participate in the program.

Income Tax - Adjustments, Deductions, and Credits: The estimates are based on actual claims by taxpayers, reports published by the Joint Committee on Taxation, and current federal law. Many of the adjustments are linked to federal tax provisions that have expired. Consequently, repealing these provisions would not impact AGI tax revenue unless: (1) the Congress enacts legislation to extend the provisions beyond tax year 2015; and the reference in Indiana statute to the IRC in effect on a particular date is updated to include such legislation.

In addition, the bill requires taxpayers continue to adjust their income as if certain provisions were not eliminated until tax year 2020. In tax year 2020, the bill requires taxpayers to make all necessary income adjustments associated with the adjustments for accelerated depreciation for disaster assistance property, to expense certain refinery property, to expense film and television production costs, and the loss of the preferred stock treated as ordinary income. The FY 2021 revenue loss associated with these adjustments is indeterminable. It is assumed that some taxpayers will continue to carry forward unused credits. The bill does not prevent taxpayers from carrying forward unused credits if it was authorized by the specific credit statute.

Explanation of Local Expenditures:

Explanation of Local Revenues: *Local Option Income Taxes (LOIT):* Eliminating various state income adjustments and deductions will affect Indiana taxable income, so counties imposing local option income taxes (LOIT) could potentially experience a change in revenue. The bill also repeals the county income tax credit for the elderly or permanently disabled. LOIT collections on a statewide basis could be increased by an estimated $2.7 M in FY 2016 and FY 2017. The additional revenue will continue in subsequent years.

In 2012, the county income tax credit for the elderly or permanently disabled was claimed by 677 taxpayers and reduced statewide LOIT revenue by $23,875.

Sales Tax: Local revenues could decrease to the extent that a local unit receives distributions from Sales Tax revenue.

State Agencies Affected: Department of State Revenue; Indiana Economic Development Corporation; Office of Community and Rural Affairs; Indiana Housing and Community Development Authority; Indiana State Education Department; Indiana Department of Natural Resources; Indiana Commission for Higher Education; Ports of Indiana.

Local Agencies Affected: Counties with a local option income tax.

Information Sources: LSA Income Tax database; Joint Committee on Taxation; Wolters Kluwer CCH, *2015 U.S. Master Tax Guide*, November 2014. *Tax Increase Prevention Act of 2014*, H.R. 5771, P.L. 113-295, 12/19/2014. Mengle, Rocky, *State Apportionment of Business Income,* Wolters Kluwer CCH White Paper, September 2014; Indiana Department of State Reveneu, *Indiana Tax Amnesty Final Report,* July 1, 2006; Federation of Tax Administrators, *State Amnesty Programs November 22, 1982 – Present*, September 14, 2014; Resnick, Phyllis, *The Effectiveness of Tax Amnesty Programs: 1982-2002*, Center for Tax Policy, 2002; U.S. Census, *State Government Tax Collections*; Bureau of Labor Statistics, Quarterly Census of Employment and Wages, 2013 Fourth Quarter, Private, All Industry; Indiana Department of State Revenue, *Tax Competitiveness and Simplification Report*, September 2014; Allied-Signal, Inc. v. Director, Division of Taxation, 504 US, 768 (1992), No. 91-615. COST, *Sales Taxation of Business Inputs,* 2005. Bureau of Economic Analysis (BEA); *Indiana GDP*; BEA, *The Use of Commodities by Industry After Redefinitions,* 2012; Indiana Revenue Forecast 2015-2017, released December 18, 2014; MIG, Inc., IMPLAN,(2012 Indiana); Jonthan Gruber and Joshua Rauh. (2005) *How Elastic is the Corporate Income Tax Base* ; Donald Bruce, John Deskins, and William Fox. (2005) *On the Extent, Growth, and Efficiency Consequences of State*

Business Tax Planning; Donald Bruce, John Deskins, and William Fox. (2006). *On The Relative Distortions of State Sales, Corporate Income and Personal Income Taxes*; John Deskins. (2007). *Are Tax Policy Distortions Increasing?*; Donald Bruce and John Deskins. (2012). *Can State Tax Policies Be Used to Promote Entrepreneurial Activity?* Small Business Economics. Sanjay Gupta and Mary Ann Hofmann. (2003). *The Effect of State Income Tax Apportionment and Tax Incentives on New Capital Expenditures. Journal of the American Taxation Association.* Sanjay Gupta, Jared A. Moore, Jeffrey D. Gramlich, and Mary Ann Hofmann. (2009). *Empirical Evidence on the Revenue Effects of State Corporate Income Tax Policies.* National Tax Journal.

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Impact of Income Tax Adjustments, Deductions, and Credits Eliminated By the Bill		
Tax Provision	**FY 2017**	**FY 2018**
21st century scholars program contribution credit	$31,000	$34,000
Certain trade or business deductions based on employment of unauthorized alien adjustment	($3,000)	($3,000)
Discharge of debt of a principal residence adjustment	$0	$0
Enterprise employee deduction	$727,000	$712,000
Enterprise zone employment expense credit	$1,333,000	$1,363,000
Enterprise zone investment cost credit	$130,000	$128,000
Enterprise zone loan interest credit	$1,991,000	$2,015,000
Federal economic stimulus payment of 2008 deduction	$0	$0
Headquarter relocation credit	$0	$0
Historic rehabilitation credit	$184,000	$189,000
Indiana college contribution credit	$8,739,000	$8,750,000
Individual development account credit	$96,000	$98,000
Insulation deduction	$1,064,000	$1,024,000
Law enforcement reward deduction	$1,000	$1,000
Lump sum distribution from qualified plans of participants born before January 2, 1936 adjustment	($132,000)	($129,000)
Maritime opportunity district qualifying export income deduction	$0	$0
Medical savings account deduction	$82,000	$89,000
Neighborhood assistance program credit	$2,158,000	$2,150,000
Non-Indiana locality earning deduction	$3,760,000	$3,699,000
Partial Indiana lottery winnings deduction	$560,000	$530,000
Qualified disaster assistance property adjustment	$0	$0
Qualified film or television production adjustment	$0	$0
Qualified preferred stock (Fannie & Freddie losses) adjustment	$0	$0
Qualified refinery property adjustment	$0	$0
Qualifying patent income exemption	$72,000	$83,000
Residential historic rehabilitation credit	$237,000	$241,000
Solar roof vent fan deduction	$7,000	$8,000

Impact of Income Tax Adjustments, Deductions, and Credits Eliminated By the Bill		
Tax Provision	**FY 2017**	**FY 2018**
Tax credit for computer donations to certain educational facilities	$0	$0
Unemployment compensation payment in 2009 adjustment	$0	$0
Total	**$21,037,000**	**$20,982,000**